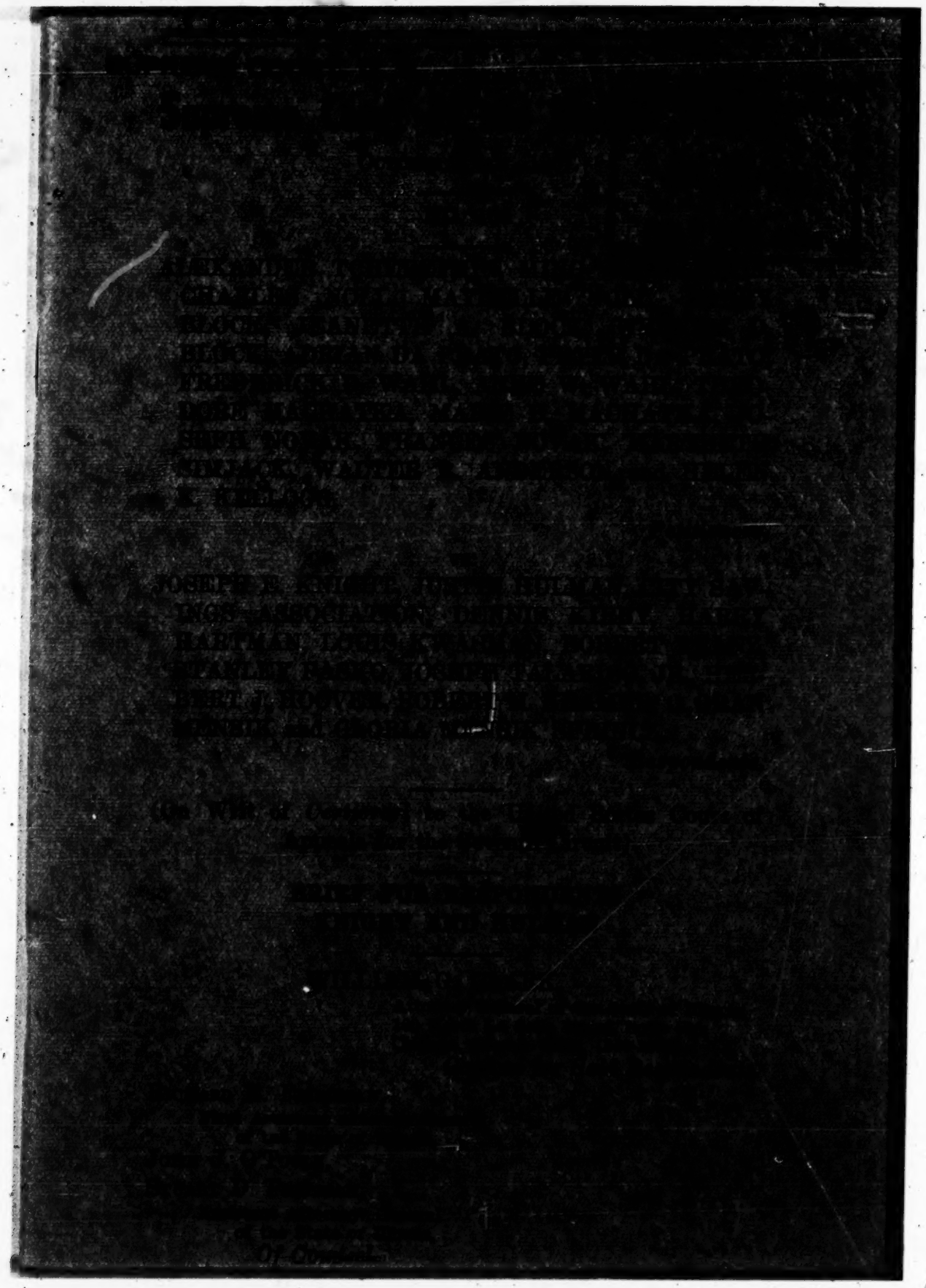

INDEX

Citations

Cases

STATUTES AND RULES

Miscellaneous

Congressional Hearings

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967.

NO. 104

ALEXANDER TCHEREPNIN, MING TCHEREPNIN, CHARLES NOLL, MAYBELLE NOLL, HARRY BLOCK, JEANETTE A. BLOCK, WERNER D. BLOCK, ADRIAN DA PRATO, PETER DA PRATO, FREDERICK D. WAHL, ANNE W. WAHL, THEODORE MACHATKA, MARIE B. MACHATKA, JOSEPH NOVAK, FRANCES NOVAK, MARYBETH SIMJACK, WALTER R. ANDERSON and HELEN K. KELLOGG,

Petitioners,

VS.

JOSEPH E. KNIGHT, JUSTIN HULMAN, CITY SAVINGS ASSOCIATION, DENNIS KIRBY, HARRY HARTMAN, LOUIS KWASMAN, ROBERT FRANZ, STANLEY PASKO, JOSEPH TALARICO, JR., HERBERT J. HOOVER, ROBERT M. KRAMER, C. ORAN MENSIK and GLORIA MENSIK SPRINCZ,

Respondents.

(On Writ of *Certiorari* to the United States Court of Appeals for the Seventh Circuit)

BRIEF FOR RESPONDENTS KNIGHT AND HULMAN

OPINIONS BELOW

The opinion of the District Court (R. 29) has not been reported. The opinions of the Court of Appeals for the Seventh Circuit (R. 43) are reported at 371 F. 2d 374.

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petitioners' and Securities and Exchange Commission's Briefs.

STATUTES AND REGULATION INVOLVED

The pertinent provisions of the Securities Exchange Act (48 Stat. 881, as amended, 15 U.S.C. 78 a, *et seq.*) are sections 2, 3(a)(10) and 10(b). [15 U.S.C. 78b, 78c(a)(10) and 78j(b)] and Rule 10b-5, the regulation involved (17 C.F.R. § 240, 10b-5) are set forth in the Appendix herein.

QUESTION PRESENTED

Whether a withdrawable capital account in an Illinois-chartered savings and loan association is a "security" within the meaning of that term as it is used in the Securities Exchange Act of 1934?

STATEMENT OF THE CASE

On June 26, 1964, respondent, Joseph E. Knight, Director of Financial Institutions of the State of Illinois, took custody of City Savings Association, an Illinois mutual savings and loan association, pursuant to the authority vested in him as such state officer under Section 7-8, Article 7 of the Illinois Savings and Loan Act

(Ill. Rev. Stat. 1965, ch. 32, par. 848) (R. 44). At that time respondent Justin Hulman was the Supervisor of the Savings and Loan Division of the Department of Financial Institutions.[1]

During the time respondent Knight assumed custody of City Savings, petitioners filed the complaint herein on July 24, 1964 (R. 2).

Four days after the filing of the instant action, a special meeting of the City Savings Association shareholders was held for the purpose of approving a voluntary plan of liquidation subject to the approval of respondent Knight. The plan was approved and the liquidators herein were elected, two of whom were and presently are employees of the state of Illinois (R. 3). The association is still in liquidation under state supervision and will remain in liquidation pending the disposition of this case Section 9-8 of Article 9 of the Illinois Savings and Loan Act (Ill. Rev. Stat. 1965, ch. 32, par. 908) (R. 31-32).

Petitioners allege in their complaint that jurisdiction of the cause is based solely on Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. 78 aa) (R. 2). Petitioners, for themselves and the class they allege they represent for the period from July 23, 1959 until June 26, 1964 (R. 12, Pet. Brief p. 4), aver that they purchased capital shares of and capital account interests of

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1. Respondent Justin Hulman presently is the Commissioner of Savings and Loan Associations of the State of Illinois, a state office created by Section 7-1, Article 7 of the Illinois Savings and Loan Act of 1965 (Ill. Rev. Stat. 1965, ch. 32, par. 841) effective August 1, 1965, who assumed the duties of the Director of Financial Institutions, who no longer has any authority over Illinois savings and loan associations (R. 19, 24).

City Savings which had done business at the same address for more than 20 years prior to the institution of this suit (R. 2). Petitioners claim that they were fraudulently induced by various solicitations from City Savings to purchase such accounts thereby constituting a violation of Section 10 (b) of the Securities Exchange Act of 1934. (15 U.S.C. 78 j (b)) and Rule 10b-5 (17 C.F.R. § 240, 10b-5) promulgated thereunder (R. 5). It is alleged that various misstatements, omissions and falsehoods were made in said solicitations by City Savings, among which was the offer to petitioners that in return for a deposit of their money in City Savings they would receive expensive premiums such as TV sets, typewriters, etc. contingent upon the amount of money deposited (R. 9).

Petitioners' sole prayer for relief is to rescind, under Section 29 (b) of the 1934 Act [15 U.S.C. 78 cc (b)] their purchases of such accounts made from the association on the grounds that such purchases were void and to recover the full purchase price paid for the shares of City Savings allegedly fraudulently sold by the association amounting in the aggregate to $20,000,000 plus interest (R. 6, 13, 14).[2] No other permanent relief is sought except preliminarily and ancillary to the final judgment, solely from the association and to the detriment of other depositors not within the alleged class.

Respondents herein and respondents City Savings Association and the three liquidators and the defendants connected with the management of the association prior to

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2. See Pet. Brief p. 5, footnote 5. The total withdrawable capital of City Savings Association shortly before the seizure by the Department of Financial Institutions of the State of Illinois was $27,512,110.

the seizure by respondent Knight, in separate motions, moved to dismiss the complaint, *inter alia,* for lack of jurisdiction in the District Court, since jurisdiction was predicated solely on an alleged violation of the Securities Exchange Act (15 U.S.C. 78a *et seq.*) (R. 14-17). The Securities and Exchange Commission (hereinafter referred to as "SEC") filed an *amicus curiae* brief supporting the complaint. All motions were denied (R. 17).

Subsequently the District Court certified to the Court of Appeals for the Seventh Circuit, the question of whether withdrawable capital shares in a savings and loan association are securities within the meaning of the Exchange Act for the purposes of an interlocutory appeal pursuant to § 1292 (b) of the Judicial Code [28 U.S.C. 1292 (b)] (R. 32). The court below granted leave to file such interlocutory appeal.

The Court of Appeals for the Seventh Circuit, with Judge Cummings dissenting, held that a withdrawable capital account in an Illinois-chartered savings and loan association was not a "security" within the meaning of that term as it is used in the Securities Exchange Act of 1934 and therefore the District Court lacked jurisdiction of this cause (R. 52).

Upon a petition for writ of *certiorari* to the United States Court of Appeals for the Seventh Circuit filed by petitioners herein supported by the SEC in an *amicus curiae* brief, the City Savings Association, including the three liquidators, and respondents herein filed briefs in opposition[3] thereto, this Court granted *certiorari* (R. 66).

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3. Defendants, C. Oran Mensik, Robert M. Kramer, Stanley Pasko, Joseph Talarico, Jr., Gloria Mensik

PREFATORY STATEMENT

Besides being named nominal defendants herein, the interest of respondents Knight and Hulman, who, as state officers, are charged with the duty of regulating and supervising all Illinois savings and loan associations (Ill. Rev. Stat. 1965, ch. 32, par. 701 *et seq.*) is to see that *all* depositors therein are properly protected and treated fairly and equally.

The petitioners, who are allegedly a group of account holders in City Savings Association, an association under the supervision of the respondents herein, claim that they are part of a class of such account holders consisting of some 5,000 persons who were issued such accounts by the association 5 years prior to the institution of the present action (Pet. Brief p. 4).[4] Petitioners are not the only depositors since there are many people who had deposited their money in City Savings Association for many years prior to July 23, 1959. If petitioners are ultimately and

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Sprincz, Robert Franz and Herbert J. Hoover, who were various officers and directors of City Savings prior to the time respondent Knight took custody (R. 2-3) did participate in the lower courts, and they have recently filed an appearance in this Court.

4. It is apparent that petitioners, basing their claim upon a violation of Section 10(b) of the 1934 Act (15 U.S.C. 78 j(b)) and Rule 10 b-5 thereunder, contend the state statute of limitations would apply (Ill. Rev. Stat. 1965, ch. 83, par. 16) (See *Errion* v. *Connell,* 236 F. 2d 447, 455 (C.A. 9); *Fratt* v. *Robinson,* 203 F. 2d 627, 634 (C.A. 9); *Fischman* v. *Raytheon Mfg. Co.,* 188 F. 2d 783, 787 (C.A. 2)).

completely successful in the outcome of this litigation[5] the pre-1959 account holders would share *pro rata* in what little is left after petitioners and the class they allege they represent (if a class action is maintainable), collect their purchase price in full. Such a result would be unconscionable and really create a chaotic situation among the remaining depositors.

This type of dilemma was never intended by Congress when it enacted the Securities Exchange Act of 1934, especially when there are no cases interpreting the term "security" under that Act. Congress foresaw some of these problems when it decided to allow the state regulatory agencies to handle the failures of savings and loan institutions by exempting them from the Bankruptcy Act.[6] This is particularly true where the state officers are better suited to permit and provide a more equitable solution than to allow petitioners to prevail over other depositors merely by a fortuity of time and on an erroneous interpretation of the Exchange Act (R. 31, 51).

SUMMARY OF ARGUMENT

Upon an analysis of the legislative history and intent of Congress after the 1929 crash, it is apparent that in Congress' attempt to regulate securities it never intended to include coverage of savings and loan accounts under the Exchange Act. Although specific attention was made to the precise account herein at issue, since they were well

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5. See *supra*, p. 4.

6. 11 U.S.C. 22. Also see *Security Building and Loan Association* v. *Spurlock*, 65 F. 2d 768, 771 (C.A. 9); *Home Savings and Loan Association* v. *Plass*, 57 F. 2d 117 (C.A. 9); (R. 48).

known and discussed at length in hearings prior to the redrafting of the present Securities Act of 1933 (hereinafter referred to as the "1933 Act") and in the Securities Act itself, they were tangently referred to as not being within the provisions of the Securities Exchange Act of 1934 (hereinafter referred to as the "1934 Act"). Basically this is due to the fact that although there is a continuity in the scheme of regulating securities the purposes of the 1933 Act and 1934 Act are different. The 1933 Act sought full disclosures with regard to the issuance of various securities and transactions therein covered while the 1934 Act, on the other hand, is primarily concerned with the regulation of the trading and subsequent disposition of securities therein covered (15 U.S.C. 78b, App. p. 45). Therefore a purely formalistic approach without regard to the purpose or substance particularly in regard to the regulation of securities has been condemned by this Court. *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350-351.[7]

Furthermore, the nature of the type of transaction involved in opening a savings and loan account, its dominant and fundamental characteristics as opposed to its less significant attributes; its resemblance to other transactions, e.g. deposits in a savings bank or a savings account in a commercial bank and its similarity to insurance, obviously excluded from the 1934 Act, all militate to the conclusion that these accounts are excluded from the coverage of the 1934 Act.

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7. Also see *SEC* v. *Universal Service Association*, 106 F. 2d 232, 237 (C.A. 7) (writ of *certiorari* denied 308 U.S. 622); 163 A.L.R. 1053.

ARGUMENT

I.

THE INTENT OF CONGRESS WAS TO EXCLUDE SAVINGS AND LOAN ASSOCIATION ACCOUNTS FROM WITHIN THE COVERAGE OF THE SECURITIES EXCHANGE ACT OF 1934.

A.

The legislative history of the 1933 Act and 1934 Act.

Shortly after the 1929 stock market crash, Congress, at the instance of President Franklin D. Roosevelt, began to investigate the securities field and markets.[8] As an outgrowth of such investigation the 1933 Act was passed for the general purpose of requiring full disclosure by all sellers of securities so that instead of *caveat emptor*, the maxim in this field would be "Let the seller also beware"[9] while the 1934 Act was primarily intended to regulate the trading of various securities and markets.[10]

Many drafts of both proposed bills were introduced in the 73rd Congress before each was enacted into law.[11] Both

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8. S. Res. 84, 72d Cong. (1932), S. Res. 56 and Res. 97, 73d Cong., (1934); S. Rep. No. 1455, 73d Cong., 2d Sess. (1934).

9. H. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933).

10. H. Rep. No. 1383, 73d Cong., 2d Sess. (1934); 78 Cong. Rec. 7595, 7938-7940 (1934); 15 U.S.C. 78b, App. 45.

11. Prior to the 1933 Act, besides other hearings being held (Footnote 8, *supra*) the following bills were considered: H.R. 4314 and S. 875 and prior to the 1934 Act the following bills were on record: H.R. 7852, S. 2693, H.R. 8720 and S. 3420; 78 Cong. Rec. 7935 (1934).

the 1933 Act and the 1934 Act were managed in the House of Representatives by the House Committee on Interstate and Foreign Commerce, chaired by Congressman Sam Rayburn and in the Senate by the Senate Committee on Banking and Currency, chaired by Senator Duncan Fletcher. Although hearings and testimony were taken on other bills[12] the ones that finally became the 1933 Act and 1934 Act were H.R. 5480 (1st session) and H.R. 9323[13] (2nd session), respectively.[14]

There were apparently no specific hearings held on H.R. 5480 in 1933 but there were hearings conducted on H.R. 4314 and S. 875.[15] Likewise it appears no testimony was taken in 1934 on H.R. 9323 but this bill was debated quite extensively in Congress.[16]

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12. *Id.*

13. Title II of H.R. 9323 enacted various amendments to the 1933 Act including redefining the term "security" in the 1933 Act. 78 Cong. Rec. 10258 (1934).

14. H.R. 5480 (1933) became Public No. 22, 77 Cong. Rec. 5195 (1933) and H.R. 9323 (1934) became Public No. 291, 78 Cong. Rec. 10847 (1934).

15. Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. (1933) and Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. (1933).

16. Hearings were held on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. (February 14 to March 24, 1934). Debate in the House of Representatives on H.R. 9323, 78 Cong. Rec. 7693-10265 *passim*, 73d Cong., 2d Sess. (1934). Debate in the Senate was in part limited to S. 3420 which was similar to H.R. 9323, 78 Cong. Rec. 8160-8713, *passim*, 73d Cong., 2d Sess. (1934).

Securities Act of 1933.

After the hearings were conducted on H.R. 4314 with its obvious shortcomings[17] the House Committee on Interstate and Foreign Commerce reported out H.R. 5480.[18]

After some short debate both Houses passed H.R. 5480 in 1933 but with various differences. Consequently conferences were held between the House and Senate resulting in the Act finally being passed in 1933.[19]

It has been repeatedly said that the primary purpose of the 1933 Act was to "provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."[20] Its purpose was to assure full publicity and information of "every *issue* of new securities to be sold in interstate commerce".[21] Concern was placed on ensuring every possible element be made known to the purchaser upon the *issuance* of a security.

As stated in the SEC brief (p. 18), representatives of the United States Building and Loan League testified on

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17. The late Dean Landis, who was one of the principal drafters of the present 1933 Act, has commented on the legislative history of that law. Landis, *The Legislative History of the Securities Act of 1933,* 28 Geo. Wash. L. Rev. 29 (1959).

18. H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933); 77 Cong. Rec. 2908 (1933).

19. H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933); 77 Cong. Rec. 3900 (1933).

20. *Ibid,* p. 23, 77 Cong. Rec. 3901 (1933).

21. H.R. Rep. No. 85, *supra* 2 (Emphasis added); S. Rep. No. 1455, 73d Cong., 2d Sess. 151-152 (1934).

H.R. 4314, a bill containing few exemptions and later scrapped for H.R. 5480.[22] Mr. Bodfish was testifying about the identical interests herein in question before this court i.e. withdrawable capital accounts or shares, when he said:

> "I can describe the operation best by saying that building and loan investments or shares are more similar to long-time deposits in mutual savings banks than they are to issues of stock or flotations of bonds."[23]

The new authors who finally drafted H.R. 5480 did incorporate various exemptions within the 1933 Act.[24] When that bill was reported out of the House it stated, *inter alia,*

> "Paragraph (5) exempts the securities of building and loan associations and similar institutions, but insists that such institutions as a condition to being exempt from the act must do a true building and loan business by confining their business to the making of loans to their members."[25]

The final conference report by the House, to resolve the differences between the two Houses, contained the following:

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22. 28 Geo. Wash. L. Rev. 29, 31 (1959).

23. Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 72 (1933). Also see Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. 94-120, *passim* (1933).

24. 15 U.S.C. 77 c.

25. H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933). Also see Jennings and Marsh, *Securities Regulation,* p. 365 (1963).

"The House bill (sec. 3 (a) (5)) exempted the securities of building and loan associations and other similar institutions when their business was substantially confined to their members. The Senate amendment limited this exemption by further requiring that these associations must not charge withdrawal or other fees in excess of 2 percent of the face value of the security. This provision in the Senate amendment was accepted with the change of extending the exemption only to institutions that did not charge in excess of 3 percent of the face value of the security by way of a withdrawal fee or otherwise.

"The Senate amendment also exempted the securities of farmers' cooperatives. This exemption is incorporated in the substitute.

"The Senate amendment provided for an exemption in the case of annuity contracts. The House bill contained no such exemption. The substitute, however, only exempts such contracts when issued by a corporation subject to the supervision of the appropriate State or Territorial governmental agency."[26]

The result appears in section 3(a) (5) of the 1933 Act.[27] It may be observed that the exemptions provided for in section 3(a) of the 1933 Act (15 U.S.C. 77 c (a)[28] are not applicable to sections 12 (2) and 17 of the 1933 Act (15 U.S.C. 77 l (2) and 77 q, respectively) sometimes referred to as the anti-fraud provisions of the 1933 Act.

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26. H.R. Rep. No. 152, 73d Cong., 1st Sess. 24 (1933), 77 Cong. Rec. 3901 (1933).

27. 15 U.S.C. 77 c (a) (5).

28. With the exception of section 3(a) (2) of the 1933 Act (15 U.S.C. 77 c (a) (2)).

Securities Exchange Act of 1934

As in the case of the 1933 Act many shortcomings and objections arose after hearings were conducted on H.R. 7852, 8720[29] and S.2693 (companion to H.R. 7852).[30] There was a great deal of redrafting and rewriting of various sections apparently not related to the issue herein.

Subsequently the Senate reported out S. 3420 and the House reported out H.R. 9323.[31]

Debate then ensued on both bills when the Senate substituted H.R. 9323.[32] The final bill was reported in the conference report by both Houses, which report contained a statement explaining parts of the bill.[33]

Although the 1934 Act represents a continuous scheme in the regulation of securities, its purpose and the evils attempted to be remedied are distinct from the 1933 Act.[34] This bill was denominated as the bill "to provide

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29. Hearings on H.R. 7852, 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2nd Sess. (1934), 78 Cong. Rec. 7935 (1934).

30. S. Rep. No. 792, 73d Cong., 2d Sess. 1 (1934).

31. *Id.*; 78 Cong. Rec. 6980 (1933) and H. Rep. No. 1383, 73d Cong., 2d Sess. (1934); 78 Cong. Rec. 7595 (1934).

32. 78 Cong. Rec. 8713 (1934).

33. H. Rep. No. 1838, 73d Cong., 2d Sess. (1934); 78 Cong. Rec. 10248-10265 (1934).

34. The 1934 Act contains a specific section setting forth its purpose (15 U.S.C. 78b) *infra,* p. 45, while the 1933 Act does not contain such provision. Also see Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of1940,* 28 Geo. Wash. L. Rev. 214, 215 (1959).

for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets."[35]

> "The chief provisions of the bill may be grouped under six headings: (a) control of credits; (b) control of manipulative practices; (c) provision of adequate and honest reports to securities holders by registered corporations; (d) control of unfair practices of corporate insiders; (e) control of exchanges and over-the-counter markets; (f) administration."[36]

The whole tenor of the 1934 Act was to control securities that are traded and the traders of such securities. Moreover the constant concern was to enhance credit and give integrity to the type of securities constantly being transferred from one person or institution to another.

Almost permeating throughout the hearings, reports and debates was the theory to protect the investments made and the operations of banks, insurance companies and savings and loan associations as opposed to the interests held by individuals in these enterprises.[37]

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35. 78 Cong. Rec. 10248 (1934).

36. 78 Cong. Rec. 7703 (1934).

37. H. Rep. No. 1383, 73d Cong., 2d Sess. 31 (1934); 78 Cong. Rec. 7702, 7864, 8017-8021, *passim*, 8097-8098, *passim*, 8187-8190 *passim*. Hearings on H.R. 7852, H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 620, 648, 685, 720, 817; Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res 97 (73d Cong.) before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 7273 (Letter from National Association of Mutual Savings Banks) (1934).

No mention was made of trading of savings account interests but rather to protect the investments made by such institutions.

It is apparent that a review of the preliminary hearings and the debates of these bills evidence no intent by Congress to include withdrawable capital accounts of savings and loan associations within the provisions of the 1934 Act.

Senator Barkley commenting on a request for an exemption on another matter by another Senator retorted:

> "MR. BARKLEY. The trouble about it is, as the Senator as a legislator knows, is trying to exempt everybody who feels that, although he is probably by the language of the bill not included, somebody, after a while may interpret him to be included, that we might unwittingly exempt many people who ought to be included. That is the difficulty about it.
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> • • • • •
>
> "MR. BARKLEY. Section 2 of the bill itself says that only those included in the proposed law. Why should anybody imagine that someone else will be included in it?"[38]

The 1964 Amendments to the Securities Exchange Act of 1934.

After necessity was found to further regulate the over-the-counter markets and those trading in them, Congress enacted various amendments to the 1934 Act.[39] A special

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38. 78 Cong. Rec. 8190 (1934). Section 2 referred to in App. 45.

39. S. 1642, 88th Cong., 2d Sess. (1964); Public Law 88-467, 78 Stat. 565.

study was prepared by the SEC before hearings were conducted on H.R. 6789 and H.R. 6793 and S. 1642 in 1963. These bills provided for registration of certain equity securities. In the technical statement prepared by the SEC, while referring to all other interests which it recommended for exemption as being "securities" it speaks of "share accounts" when referring to the savings and loan associations and concludes that there is "normally no trading interest"[40] in them.[41]

Further amplification is made by the testimony of Professor William Cary, then Chairman of the SEC and Mr. Milton Cohen, Director of the Special Study for the SEC:

> "MR. CARY. Well, sir, we do not have any jurisdiction over building and loan associations generally, and I though (sic) they were subject to other Federal regulatory agencies.
>
> MR. HARRIS. Did your study deal with that subject at all?
>
> "MR. CARY. It did not; no, sir.
>
> "MR. HARRIS. I want to know why it didn't.
>
> "MR. COHEN. This is another area that the study group did not reach because of the number of other areas they were looking at. In the case of building and loan associations, and that type of organization, frequently the interest in the association is limited to a person who is a member of the association, with savings-type interest, in an association from which he may also borrow funds. There are various kinds of

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40. S. Rep. No. 379, 88th Cong. 1st Sess. 61 (1963) (See also SEC Brief, p. 14. footnote 10, [S]avings and loan interest[s] is not a usual medium for trading in the markets.")

41. The exemption is contained in 15 U.S.C. 78 l (g) (2) (C).

these organizations; when organizations of the kind sell stock as a stock investment, they are within the purview of the Federal Securities Act, as is proposed in this bill.

"This is a matter which is under discussion among the various agencies concerned with these organizations.

* * * * *

"MR. COHEN. If I could add to that, normally in many of these organizations the person who has an interest in the association is in the nature of a savings—a savings interest. He doesn't have anything that he can usually transfer, as he can a share of stock, but in more recent years there has been a development in this area whereby stock in these organizations has been created for sale to the public as an investment. It is in this particular area that attention is being given to them within the purview of the securities acts."[42]

Congress as well as the SEC took the position that where there is normally no trading such an interest is not within the purview of the 1934 Act.

B.

Legislative history related to the withdrawable capital accounts or shares issued to petitioners by City Savings Association.

From the exhaustive analysis of the legislative history of the 1934 Act, Congress was well aware of the type of

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42. Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess., 272-273.

interests herein at issue. Such interests were discussed, debated and thoroughly considered in Congressional reports, records and hearings. Withdrawable capital accounts, then, are distinguishable from the "variable schemes" [43] that may be perpetrated upon the public and which should ordinarily be curtailed or controlled within the statutory scheme.

However, there appears to be no desire by Congress to include these accounts under the 1934 Act since they were not the type of interests to be covered by the purposes or operation of the Act.

There is absolutely no suggestion or evidence by either petitioners or the SEC that Congress manifested an intent to include these types of accounts within the purview of the 1934 Act.

Instead both petitioners and the SEC's approach is merely formalistic without even attempting to look to substance.[44] Their reasoning throughout their briefs has been that if an instrument is identified in one piece of legislation as a "security" i.e., the 1933 Act, it is always and for all purposes a "security" wherever the same or similar definition is used without considering the purpose of that particular Act. In that connection it may be noted that the SEC is in error in quoting from S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934) (SEC Brief, pp. 10 and 20). That report referred to the term "security" in S. 3420 (not the final 1934 Act) which was "substantially the same as [that contained] in the Securities Act

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43. See *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 299.

44. Such an approach has been looked upon with disfavor by this Court, *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344.

of 1933," [45] but the term "security" was later changed after the conference of both Houses as appears in H. Rep. No. 1838, 73d Cong., 2d Sess. 3-4 (1934); 78 Cong. Rec. 10248 (1934).

In any event this Court has unequivocally stated with regard to interpreting securities legislation:

> "Some rules of statutory construction come down to us from sources that were hostile toward the legislative process itself and thought it generally wise to restrict the operation of an act to its narrowest permissible compass. However well these rules may serve at times to aid in deciphering legislative intent, they long have been subordinated to the doctrine that

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45. The term "security" was defined in S. 2693 (since S. 3420 is not available the writer understands that the definition of "security" was the same as in S. 3420) as follows:

> "The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement, oil, gas, and other mineral royalties and deeds, collateral—trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, or in general, any instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing, *but the term 'security' as used in this Act shall not include any direct obligation guaranteed as to principal or interest by the United States.* (Emphasis added). Hearings on S. Res. 84, 72d Cong. (1932); S. Res. 56 and S. Res. 97, before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6423 (1934).

> courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." (Footnotes omitted)[46]

This Court has also held that when dealing with federal statutes the meaning of terms therein contained are federal questions. Mr. Justice Douglas in discussing the meaning of "insurance" and "annuity" as it is used in the 1933 Act and the Investment Company Act of 1940 (15 U.S.C. 80 a) in *SEC* v. *Variable Annuity Life Insurance Co.*, 359 U.S. 65 at page 69 (1959) said:

> "In any event how the States may have ruled is not decisive. For, as we have said, the meaning of 'insurance' or 'annuity' under these Federal Acts is a federal question."[47]

Since the issue in the instant case is a "federal question" it is necessary to construe the details of the 1934 Act in conformity with its "dominating general purposes" and read the "text in the light of context" and conclude that withdrawable capital accounts in the Illinois savings and loan association are not a "security" within

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46. *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344 at pages 350-351. Also see *SEC* v. *Universal Service Association*, 106 F. 2d 232, 237 (C.A. 7) (writ of *certiorari* denied); 163 A.L.R. 1053.

47. Also cited to by Mr. Justice Harlan in *SEC* v. *United Benefit Life Insurance Co.*, 387 U.S. 202, 210.

the meaning and intent of the 1934 Act as set forth in the "generally expressed legislative policy." [48]

Possibly the only hint of any Congressional consideration of share accounts with regard to the 1934 Act was the 1963 hearings and the subsequent exemption made in the 1964 amendments. On the basis of this discussion and the exemption it is erroneous to conclude that there was any intent to include such accounts in the rest of the 1934 Act since such reasoning is what Professor Louis Loss calls supererogation.[49] Just as an exemption was made in the 1933 Act for "insurance" there is no implication that there was any intent to include "insurance" within the ambit of the 1933 Act.[50]

Neither petitioners nor the SEC cite any case that either holds that Congress intended to include withdrawable accounts in the 1934 Act or that the courts even held that these identical interests at issue herein, were construed to be a "security" under the 1934 Act.[51]

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48. Note that the definitions contained in Section 3(a) of the 1934 Act (15 U.S.C. 78c), *infra*, p. 47, starts "3.(a) When used in this title, unless the context otherwise requires".

49. 1 Loss, *Securities Regulation*, (1961 ed.) p. 497.

50. Section 3 (a) (8) of the 1933 Act (15 U.S.C. 77 c (a) (8)).

51. Almost all the cases cited relate to the meaning of the term "security" under the 1933 Act or under state law (not here relevant since as this Court has held this is a "federal question", footnote 47, *supra*). The court in *Archer & Co.* v. *SEC*, 133 F. 2d 795 (C.A. 8), *certiorari* denied, 319 U.S. 767, to the contrary appears to be discussing face-amount certificates, rather than share accounts, as contemplated under the Section 2(a) (15) of the Invest-

Even a review of the allegations in the complaint in the present matter is further support that the petitioners are only concerned with the issuance of the accounts to them. Not one allegation is made that there was a *sale* from one account holder to another party. All petitioners are purchasers of accounts (R. 4-5).

The SEC concedes that the decision of the court below has no effect on share accounts under the 1933 Act.[52] There is no strong policy reason to have share accounts come under the 1934 Act since there are no sales of them except at issuance by the savings and loan associations.[53]

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ment Company Act of 1940 (15 U.S.C. 80a-2(a)(15)) which usually fluctuate due to their active trading. Furthermore, there is no indication that the institution involved was a true building and loan association which limited its business to its members as in the instant case. In the *Los Angeles Trust Deed and Mortgage Exchange* v. *SEC*, 285 F. 2d 162 (C.A. 9), *certiorari* denied, 366 U.S. 919, the court after concluding that a "security" was involved under the 1933 Act, did not even discuss whether this "variable scheme" was a "security" under the 1934 Act. There were also repurchases of these instruments at discounts as well as further sales. Moreover the enterprise sought to be enjoined and which later ended up in receivership was not regulated by any governmental agency except the SEC. All of these factors distinguish the *Los Angeles Trust Deed* case from the instant action.

52. See footnote 2 in the SEC brief, p. 3.

53. Those whom the SEC contend are solicitors of such accounts are covered under the anti-fraud provisions of the 1933 Act (Sections 12(2) and (17); 15 U.S.C. 77 l (2) and 77q). If the solicitors violate the 1933 Act the SEC may still exercise control under specific provisions of the 1934 Act which relate to 1933 Act violations (15 U.S.C. 78o(b)(5)(D)(E) and 78o-3(l)(2)(B). These solicitors never trade these accounts but merely open accounts in

Nor have the petitioners cited any authority of any sort to show why this action must be maintained under the 1934 Act.

There have been many commentaries on the possible abuse of litigants of Rule 10b-5 promulgated under the 1934 Act especially when no remedy may be available under the 1933 Act. There is no special contention raised by petitioners that they only have a claim, if any, under the 1934 Act. Nevertheless they only seek relief under the 1934 Act and none under the 1933 Act.

In any event, Professor Louis Loss has written a critique in his treatise regarding the gravitation of almost all claims for recovery under Rule 10b-5 with little recourse to other provisions of both the 1933 and 1934 Acts. In discussing the number of cases arising under Rule 10b-5, he wrote:

> "With deference to the court, is not this potpourri the *reductio ad absurdum* of the view which opens Rule 10b-5 and § 17(a) to buyers who for some reason find their express remedies under the 1933 act to be inadequate? . . . Rule 10b-5 was adopted to protect defrauded sellers, whom Congress had largely overlooked in its concern for defrauded buyers under the 1933 act. . . .

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solely federally insured savings and loan associations (SEC brief pp. 4, 23-24). Such registration requirement was innovated after the SEC filed its *amicus* brief in the trial court in 1964. Moreover, the activities of these solicitors have been severely curtailed by the Federal Home Loan Bank Board, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation by reducing the amounts they may place in various institutions and the amount of commission that they may receive. (See Federal Home Loan Bank Board Regulation 563.25, 12 C.F.R. § 563.25).

"The danger, of course, is that the continued denigration of buyer's express remedies under the 1933 act in favor of Rule 10b-5, and even § 17(a) of the 1933 act itself, may persuade the Supreme Court—which has yet to consider *any* implied remedy under the SEC statutes—to throw its collective hands *up* and the *Kardon* doctrine *out*. To be sure, the approach advocated here leaves the basic anomaly of favoring sellers, for whom by and large Congress created no specific remedies, over buyers, who were taken care of in some detail in the Securities Act. Yet, apart from abandoning sellers to their common law remedies there seems to be only one other alternative open: The courts might try to make a logical pattern by reading the defenses and limitations of §§ 11, 12, 13 and 15 of the Securities Act into *sellers'* actions under Rule 10b-5. But that would require too substantial a judicial rewriting of the statutes. Consequently, it seems relatively safe to predict that the Supreme Court will someday have to choose between abandoning the seller altogether and accepting the anomaly of favoring him over the buyers as inevitable under a system of securities regulation which after all is not an integrated code adopted at a single legislative sitting, however one may try to construe it so."[54]

Of course, it is not necessary for the Court to even go as far as Professor Loss suggests but merely to hold that savings and loan accounts were not intended to come within the purview of the 1934 Act and therefore no claim is stated herein under Rule 10b-5 thereunder.

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54. 3 Loss, *op. cit*, pp. 1789-1790.

II.

THE NATURE OF A SAVINGS AND LOAN ASSOCIATION ACCOUNT WAS NOT INTENDED TO FIT WITHIN THE MEANING OF THE TERM "SECURITY" AS USED IN THE SECURITIES EXCHANGE ACT OF 1934.

A.

The Nature of a Savings and Loan Association Account.

Even though there is no Congressional intent to include a withdrawable capital account within the scope of the 1934 Act an approach that construes the basic, fundamental and dominant characteristics of this transaction is further support that such an instrument is not within the meaning of the term "security" in the 1934 Act.

The interests that are involved in this case universally come into being as follows: when a person opens up a withdrawable capital account, more commonly known as a "savings account," in any savings and loan association, including the one herein at issue, he submits some money to the association and he signs what is usually called a "signature card." This "signature card," besides identifying the person, does indicate that it constitutes that person's proxy in the association and makes him a "member" thereof. At that time he is usually issued a passbook or certificate, which would reflect the amount of the deposit thereon. Normally, nothing further is done by the person nor the association, except the entry in the passbook of other deposits or withdrawals of money and dividends that are declared by the association.

While the becoming of a "member" in a going and thriving savings and loan association does create a proprietary

interest within the association under the Illinois Savings and Loan Act, (Ill. Rev. Stat. 1965, ch. 32, par. 701 *et seq.*) such a position is more nominal than real. The person who has opened such an account probably is solely interested in keeping his money in a place to earn dividends.

Although there are voting rights attached to the share account, the technical and almost surgical approach by particular petitioners (Pet. Brief, pp. 4-14) and in some measure by the SEC (Sec. Brief, pp. 5-7) without looking to the reality of this transaction indicates once again that only form is being entertained over substance.

Therefore, the outstanding characteristics of this account besides what has been stated above are as follows: permissibly issued in unlimited amounts; as not made subject to the securities article of the Uniform Commercial Code; as not negotiable and transferable only by assignment; as subject to forced redemption and retirement on call of the board of directors; as fully matured and withdrawable when issued; as without preemptive rights and as the limited right to inspect the books and records of the association solely as to his own account (R. 47).

It is possible that when a person's account is in an institution which has suffered financial difficulties his voting rights may be of some importance as in the instant case. Nevertheless, as will be discussed later, state regulation controls, not the Bankruptcy Act.[55]

What, then, is the "economic reality"[56] of the placing of money in a savings and loan association and the receipt by such person of a passbook? Surely his voting

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55. See footnote 6, *supra*.

56. *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 298.

rights are neither thought of nor of any concern. His only desire is to accumulate a balance, receive dividends and withdraw his money on demand and he almost always does. There is no need to purchase or sell his account since he will have the same status merely by opening or withdrawing such an account in any going institution.

It is apparent that something besides an "equity" is involved. The savings and loan account holder does not even consider himself in that capacity, since his only concern is to be able to have the association return to him the dollar value of his account on demand, together with credited earnings. This is precisely the same characteristic of any short-term debtor-creditor relationship. His interest under various historical precedents, also has been construed to be in the debtor-creditor category.[57]

It has also been shown that the withdrawable capital account is very much like a deposit in a commercial bank's savings account or mutual savings bank.[58] There is even a strong Congressional policy to treat these accounts alike for purposes of federal insurance[59] and under the Internal Revenue Code.[60]

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57. Prather, *Savings Accounts in Savings and Loan Associations* 15 Bus. Law. 44-69 (1959); *Benton's Apparel* v. *Hegna,* 213 Minn. 271, 7 N.W. 2d 3; *Bakerstown* (*In re Kruger's Estate*), 39 P. 2d 381 (Sup. Ct. Wash.) *Savings Association,* 122 A. 2d 411 (1956); *Costine* v. *Whitham* (*In re Krueger's Estate*), 39 P. 2d 381 (Sup. Ct. Wash. (1934); *Harn* v. *Woodword,* 50 N.E. 33.

58. Ibid. Livingston, *Chicago Daily News,* September 28, 1967, p. 51 and October 3, 1967, p. 35.

59. 12 U.S.C. 1726.

60. 26 U.S.C. 591.

There has been a decided interest to be sure especially under federal legislation, to treat the withdrawable capital account much like other savings accounts.

This was particularly emphasized by the chairman of the SEC during the 1963 hearings on the proposed amendments to both the 1933 Act and 1934 Act.

> "Both bills would apply to bank securities to the same extent as they would apply to the securities of other corporations with securities traded in the over-the-counter market. There is also no disparity between the treatment accorded securities issued by banks and savings and loan associations of similar institutions. Since deposits in savings and loan type associations, unlike deposits in banks are represented by share accounts and depositors are commonly referred to as shareholders, section 6 (c) of the bills provides an exemption from the registration requirements of the bills for securities issued by such institutions 'other than permanent stock, guarantee stock, permanent reserve stock, or any similar certificate evidencing notwithdrawable capital.' *The sole purpose of this exemption is to assure that depositors in savings and loan associations and similar institutions are treated exactly as bank depositors* and not as shareholders of equity securities for the purpose of the coverage criteria contained in the bills."[61]

The need for equal treatment is seen in the competitive desire of banks, savings and loan associations and

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61. Hearings on H.R. 6789, H.R. 6793 and S. 1642 before the Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. 1361 (1963) (Emphasis added); Also see footnotes 23, 42, *supra,* H.R. Rep. No. 234, 73d Cong., 1st Sess. (1933).

similarly regulated institutions to encourage people to open accounts.[62]

In a sense a life insurance policy or a fixed annuity (not "variable" as construed by this court in *Variable Annuity* case, *supra* and *United Benefit* case, *supra* but as understood under the 1933 Act)[63] is very much like a savings and loan association account since the policyholder in a mutual company has virtually the same rights and duties as a member of a savings and loan association.[64] Such a policyholder has voting privileges but his main interest is in the nature of the policy[65] which is in the form of forced savings and protection upon his death or income at some future date. He is also entitled to dividends as an accountholder in a savings and loan association.[66]

The similarities between mutual savings and loan associations and mutual insurance companies were recognized by the SEC in 1963. The following is the testimony that

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62. Dividend and interest rates are invariably set by the regulations of the Federal Home Loan Bank Board Federal Deposit Insurance Corporation, Federal Savings and Loan Insurance Corporation, Board of Governors of the Federal Reserve System and Comptroller of the Currency.

63. See footnote 26, *supra*.

64. Ill. Rev. Stat. 1965, ch. 73, par. 613 *et seq.*

65. Ill. Rev. Stat. 1965, ch. 73, pars. 647-677 *passim*. So too is the account-holder's form subject to the approval of the Illinois State Commissioner of Savings and Loan Associations. Ill. Rev. Stat. 1965, ch. 32, par. 768(a).

66. Ill. Rev. Stat. 1965, ch. 73, par. 666.

transpired by Mr. Cary regarding the amendments suggested at that time which were enacted in 1964:

> "With respect to savings and loan associations, an effort is made to treat them in essentially the same manner as insurance companies are treated, that is, mutual savings and loan associations will be exempt, just as mutual insurance companies are.
>
> "In the case of stock savings and loan associations, the stock, if purchased and traded as an equity investment, is subject to H.R. 6789 just as is stock of insurance companies.
>
> "On the other hand, savings accounts in savings and loan associations are not subject to the bill, just as insurance policies are not covered. Because of the fact that most savings and loan associations issue so-called shares, which in fact merely evidence the existence of a savings accounts, special provision had to be made in proposed section 12 (g) (2) (C) of the bill to exempt that type of 'share.'"[67]

He also said:

> "MR. CARY. We didn't make that statement, but we do say that mutual insurance companies are not included under the bill because the buyers of mutual insurance companies are fundamentally buying insurance. That is the first point. They are buying an insurance policy and not stock. Furthermore, because there is no stock, there is no trading in the stock.
>
> "On the other hand, in stock companies, investors may be stockholders without even having an insurance policy in the company.
>
> "In stock companies, we are interested in providing information to people who are engaged in trading in that stock. They must have the information. In mu-

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67. Hearings on H.R. 6789, H.R. 6793, and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. 1213 (1963).

tual companies, there are no shares being traded and, therefore, they don't need to know this kind of information. That is why we draw a distinction, Mr. Chairman, between mutual insurance companies, on the one hand, and stock insurance companies, on the other.

"MR. HARRIS. In other words, if there is no public trading, then any management abuses are none of your business?

"MR. CARY. They are none of our business legally, that is correct.

"I think the answer will be yes. It is not that we are not unhappy.

"Mr. Loomis has clarified that in my mind by pointing out that, since the holders in mutual companies are policyholders, any wrongdoing would be the responsibility of the State Superintendent of Insurance."[68]

The majority of the court below placed great weight on the close resemblance of these two types of institutions and their treatment by Congress (R. 50-51) and properly so since this argument more closely than anything petitioners or the SEC have submitted evidences the intent of Congress.

It is also apparent that no matter how you treat the account holders or policyholders in any of the enterprises discussed above the risk is invariable on that institution and not on the individual while it is in operation.

Another erroneous approach taken by the petitioners is to consider this transaction on purely a semantic basis. Their circuitous argument is that since this is denominated a "share" or "stock" (SEC Brief, p. 13) in certain legisla-

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68. House Hearings, *supra*, pp. 309-310.

tion or in testimony taken before Congressional hearings it is a share or stock and therefore a "security." This reasoning is fallacious since the terminology which is used is due to the historical development of savings and loan associations.

In analyzing the origins of the savings and loan association, Mr. Prather, general counsel to the United States Savings and Loan League, has indicated that the term "share" was used to encourage a mutuality or equality of status among the members of the association.[69] Further confusion was later caused by the various forms these shares in the mutual association would take i.e. due paid on installment plan shares, optional plan shares, prepaid shares, etc. (Pet. Brief, p. 5). On top of all this was added the development of true stock associations (as opposed to a true building and loan association confining its business to its members)[70] which created a class of owners as in any stock-company.

In any event City Savings, a mutual association, confining its business to its members, employed nomenclature which is much closer to the true nature of the transaction. These accounts are more often than not referred to in the commercial world as "savings accounts".[71]

Nevertheless, the label employed is not the determining factor but the actual character and qualities of such accounts.

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69. 15 Bus. Law. 52, 64.

70. See the testimony of Messrs. Cary and Cohen, pp. 17, 18 *supra.*

71. 15 Bus. Law. 52.

Therefore, a more reasonable analysis is to appraise the transaction within the economic realities and within the basic framework as understood by the parties thereto and as carefully considered by those who testified before Congressional hearings and in Congress itself.

B.

The term "security" under the 1934 Act.

It has been pointed out that not one case cited has considered the definition of "security" under the 1934 Act.[72] It has also been shown that although the definition of security in Section 3(a) (10)[73] is similar in the 1933 and 1934 Acts, there are differences.

One is the omission of the term "evidence of indebtedness" and the other is the addition of the following:

> "but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

It is suggested in both briefs heretofore filed that there is no apparent reason for this omission or addition, except the term "evidence of indebtedness" is inconsistent with the instruments excluded from the definition.

An analysis of the derivation of the exclusion reflects some basis on the transactions not included in the 1934 Act.

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72. See footnote 51, *supra.*

73. 15 U.S.C. 78 (c) (a) (10).

. The SEC has inferred that the exclusion was only intended to apply to short-term commercial paper,[74] Although there appears to be superficial merit to their argument there is no support in the legislative history of this exclusion. The exclusion has more far reaching effect than just commercial paper. Why then in section 15 of the Act originally passed in 1934 was there a reference to ". . . any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) . . ." if such paper were already not included.[75]

Congress intended to exclude transactions other than short term commercial paper since it already excluded commercial paper in other sections of the 1934 Act. Furthermore if Congress intended to have the same definition in both the 1933 Act and 1934 Act then it would have enacted the identical definition. Therefore, the exclusion in a subsequent act with a similar definition evidences a specific intent not to include such or related transactions within that definition.

Another factor to be evaluated is the S. 2693 definition which excluded direct obligations guaranteed as to principal or interest by the United States (footnote 45, *supra*). Such instruments included Reconstruction Finance Corporation bonds and other such governmental securities. It was later decided to include these items in the "exempted security" class.[76]

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74. See SEC Brief, p. 22, footnote 17.

75. Section 15 of original act. In the amended act this same language has been employed. 15 U.S.C. 78c.

76. Section 3(a)(12) of the 1934 Act. (15 U.S.C. 78c (a)(12)) These and other government and municipal

It is therefore apparent that the exclusion in Section 3(a) (10) as quoted above is much broader and does include petitioners interests.

With the omission of evidence of indebtedness and the exclusion hereinabove set forth there are several factors that are related to these accounts.

The term "evidence of indebtedness" was deleted from the 1934 definition thereby leaving only notes, bonds and debentures in the debtor-creditor transactions.

One SEC release has shed some light on what constitutes an "evidence of indebtedness" under the 1933 Act which would be of some aid in the construction of the omission of such term under the 1934 Act. With regard to whether trading stamps were "evidence of indebtedness" the Commission view was that such stamps were not "securities" within the meaning of the 1933 Act. It was also said that streetcar tokens, meal tickets, Christmas gift certificates, box tops, railroad or theatre tickets and others too numerous to mention were also "evidence of indebtedness" not included within the purview of the 1933 Act. The release indicated the legislative history and other provisions of the statute indicate that the Congress did not intend to include such items within the scope of the statute."

Another development in the legislative history of term "security" is that the very bill H.B. 9323, that became the

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bonds were actively traded on the over-the-counter markets and therefore there developed the "exempted security" class. Hearings on H.R. 7852, 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 685-687 (1934).

77. SEC Reg. § 231.3890, Release No. 33-3890 (1958). Also see 1 Loss, *op. cit.*, pp. 455, 495.

1934 Act contained an amendment to the 1933 Act definition of "security" which retained the term "evidence of indebtedness" without the exclusion as set forth above.[78]

Couple this with the specific language of transactions *not included* in the definition of "security" under the 1934 Act, the only apparent ordinary debtor-creditor transactions remaining specifically included are long term notes, bonds and debentures.

C.

Relationship of the withdrawable Capital Account to the definition of "security" as it is used within the meaning of the 1934 Act.

Respondents are in full agreement and support of petitioners' appeal to have the 1933 Act and 1934 Act liberally and as broadly construed by this Court as it did in last term's decision.[79] Such a construction is made by complying with the specific intent manifested by Congress.

The 1934 Act definition of "security" bears a close relationship to the 1933 definition but has markedly different structure as described herein.

Likewise looking at the withdrawable capital account, as to substance rather than form and as the commercial world does, it most closely resembles an instrument arising out of a short-term debtor-creditor relationship than any other category in the definition of "security" in the 1934 Act.

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78. 78 Cong. Rec. 10263 (1934) and footnote 13, *supra.*

79. *SEC* v. *United Benefit Life Insurance Co.*, 387 U.S. 202.

Such an understanding is borne out by the testimony that developed before one of the bills considered prior to the enactment of the 1933 Act.

The majority in the court below has placed emphasis on this development (R. 50).

In the hearings on S. 875 various Senators indicated that the term "evidence of indebtedness" bore a close relationship to accounts in building and loan associations and various short term banking transactions.[80]

There appeared to be a desire to delete this phrase relating to debtor-creditor relations other than those enumerated due to the fear of banks and the Federal Reserve Board that it would "radically interfere with the ordinary commercial banking transactions"[81] Instead of omitting the term, an amendment was made to the original proposed bill to exempt certain short-term debtor-creditor transactions (Section 3 (a) (3) of 1933 Act, 15 U.S.C. 77c(a) (3)). While the Senators were on that subject of such a proposed amendment to the pending Securities Act of 1933, in the taking of the testimony of Mr. Huston Thompson, attorney at law, before the Senate Committee, the following was interjected:

> "SENATOR BARKLEY. Mr. Thompson, while on that subject let me ask you this question. Have you

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80. Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. pp. 94-120 *passim* (1933).

81. Senator Glass' statement in Senate Hearings, *supra*, pp. 98-99.

given any thought to exempting building and loan associations." [82]

Thereupon colloquy followed concerning the various types of associations that existed then, the various forms of accounts and stock issued much like what we discussed in this brief.

Senator Barkley further expressed his feeling regarding the nature of withdrawable accounts in building and loan associations by reading a telegram into the record from a Kentucky institution, as follows:

> "Their stock is based on real estate mortgages and is similar to deposits in savings banks and different in every respect from stocks sought to be controlled." [83]

Therefore we can see the very same 73rd Congress that passed the 1933 and 1934 Acts felt that the term "evidence of indebtedness" was very closely related to withdrawable accounts in savings and loan associations and banking transactions together with the desire to exclude withdrawable accounts from control under these acts.

Not one case cited by either petitioners or SEC specifically holds any transaction was a "security" under the 1934 Act; [84] no less a case regarding savings and loan accounts.

From the legislative intent, from the nature of the transaction, from policy reasons where there is state regulation, withdrawable capital accounts are not within

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82. Senate Hearings, *supra* at p. 99.

83. Senate Hearings, *supra* p. 113.

84. See footnote 51, *supra*.

the meaning of the term "security" as defined in the 1934 Act.

D.

State Regulation of Withdrawable Capital Accounts.

Perhaps the most reasonable analysis accorded the dearth of case law on this issue was expressed by the SEC in their memorandum submitted in support of petitioners' writ for *certiorari* when it said:

> "Perhaps because savings and loan associations are subject to state regulatory supervision, over the years the Commission has rarely found occasion to seek to enjoin violations of the federal securities laws by such associations and this accounts for the paucity of case law."[85]

State regulation of savings and loan associations was of paramount consideration by this Court in *Hopkins Federal Savings and Loan Association v. Cleary,* 296 U.S. 315. That case arose during the depression and was decided subsequent to the enactment of the 1934 Act.[86] The atmosphere of the time was very dismal for such institutions due to the number of failures of these enterprises and other related types of organizations. The Court, nevertheless, in describing state savings and loan associations as being quasi-public instruments speaking through Mr. Justice Cardozo said:

> "How they shall be formed, how maintained and supervised, and how and when dissolved are matters of governmental policy, which it would be an intru-

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85. SEC's memorandum in support of Petition herein, p. 10.

86. Also see *Veix* v. *Sixth Ward Building and Loan Association,* 310 U.S. 32.

> sion for another government to regulate by statute or decision, except when reasonably necessary for the fair and effective exercise of some other and cognate power explicitly conferred."[87]

In the instant action as well as in that case the state's concern is other than "pecuniary"[88] but to protect and ensure equal treatment of all depositors as opposed to one class (petitioners).

Invariably the only time a situation may arise is when, as in the present matter, a savings and loan association is in liquidation due to financial reverses or even mismanagement. Clearly this is not the time for a group of depositors to recover in excess of his fellow depositors. This is where as this Court said in the *Hopkins* case, the state role is best suited to handle such situations. The SEC, has recognized this in both its memorandum submitted herein[89] and in the trial court, of this action when it supported respondents herein in opposition to petitioners' motion for an appointment of a receiver.

It is when an association is in liquidation that the state's regulatory function is peculiarly necessary in view of the exemption of such associations from the operation of the Bankruptcy Act.[90] It would result in a breakdown of such regulatory power if one group, merely by a fortuity of time and some alleged acts by management, should pre-

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87. *Hopkins* case, *supra*, at page 337.

88. *Id.*, p. 339.

89. See p. 40, *supra*.

90. 11 U.S.C. 22. Also see *Hopkins* case, *supra*, pp. 328-329.

vail at the expense of others who are in the identical situation.

The SEC probably has been always sympathetic to this need for regulation up until the time it had filed an *amicus* memorandum in the trial court in 1964.[91] This is apparent in the attitude the SEC took with regard to the ordinary types of "insurance" as opposed to the "variable annuity" situations which are not regulated as much as insurance by the state authorities.[92]

When an institution is viable there is almost no likelihood of any contest by an account-holder or policyholder. The result is that almost invariably the investment risk is on the institution. To protect this risk these institutions are closely supervised by the state authorities.[93]

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91. There has been absolutely no regulation by the SEC of true savings and loan associations under the 1934 Act until the instant action. Prior thereto for more than 30 years the SEC has either taken the position that savings and loan associations and the accounts of their members are either exempt (Securities and Exchange Commission Release No. 26, October 22, 1934 relating to accounts in associations in liquidation) or not included (testimony of former SEC Chairman Cary, p. 31, *supra*). Since this case the SEC has taken a more active role with regard to savings accounts despite the restrictions put on the more than 96% of savings and loan associations, (See SEC Brief, p. 3, footnote 1) which are regulated not only by the state (Ill. Rev. Stat. 1965, ch. 32, par. 705) but by other federal agencies. (See letter of such agencies dated December 16, 1966). Also see footnote 53, *supra*.

92. *Variable Annuity* case, *supra*, at 68, 74 (concurring opinion), 99-101 (dissenting opinion); *United Benefit* case, *supra* at 210.

93. *Variable Annuity* case, *supra*, at 77-80, 91 (concurring opinion), 99-101 (dissenting opinion); *United Benefit* case, *supra* and *Hopkins* case, *supra*.

When an institution is in financial difficulties then the individual whose interest is in jeopardy seeks to extricate himself. Nevertheless even in this situation the state agencies are particularly adjusted to this role.

The liquidation process, although spelled out in the Illinois Savings and Loan Act,[94] has been summed up as follows:

> "From the time of an officially determined insolvency or action to liquidate, however, the savers' creditorship status becomes classified as secondary to those outside creditors who must be paid first. They share pro-rata on a simultaneous and equal basis in the assets remaining."[95]

Petitioners and the SEC have advanced no argument to change this logical and orderly liquidation of City Savings which is being supervised by the state.

Consequently no support is found in the statutes, legislative history, legislative intent, in any case, nor in any policy argument to overturn the decision below by the Court of Appeals for the Seventh Circuit.

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94. Ill. Rev. Stats. 1965, ch. 32, pars. 901-927. Also see Ill. Rev. Stats. 1965, ch. 73, pars. 799-833 (liquidation provisions of the Illinois Insurance Code). Investments by insurance companies as well as savings and loan associations are regulated by statute. Ill. Rev. Stats. 1965, ch. 73, pars. 736-737.22a. For a comparison to savings and loans see Ill. Rev. Stats. 1965, ch. 32, pars. 791-804.

95. 15 Bus. Law. 63; Russell, *Savings and Loan Association*, p. 304 (2d ed.).

CONCLUSION

For the foregoing reasons, respondents Knight and Hulman respectfully pray that the judgment of the Court of Appeals for the Seventh Circuit be affirmed.

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APPENDIX

Section 2 of the Securities Exchange Act of 1934 reads as follows (15 U.S.C. 78b):

"Necessity for regulation

"For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

"(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit directly affect the financing of trade, industry, and transportation in interstate commerce, and directly effect and influence the volume of interstate commerce; and affect the national credit.

"(2) The prices established and offered in such transactions are generally disseminated and quoted

throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

"(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

"(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, and precipitated, intensified, and prolonged by manipulation and sudden unreasonable fluctuations of security prices and by excessive speculation on such exchange and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit."

Section 3(a)(10) of the Securities Exchange Act of 1934, provides, 15 U.S.C. 78c(a)(10):

"3. (a) When used in this chapter, unless the context otherwise requires—

* * * * *

"(10)The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust, certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

Section 10(b) of the Securities Exchange Act of 1934 is (15 U.S.C. 78j(b)):

"Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 promulgated by the SEC pursuant to the Securities Exchange Act of 1934 is as follows (17 C.F.R. § 240, 10b-5):

"Rule 10b-5. Employment of Manipulative and Deceptive Devices.

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud.

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."